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# Salomon Forex, Inc. v. Tauber - The Sophisticated Trader and Foreign Currency Derivatives under the Commodity Exchange Act

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**Cover Page Footnote**
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# NOTES

## *Salomon Forex, Inc. v. Tauber* — The "Sophisticated Trader" and Foreign Currency Derivatives Under the Commodity Exchange Act

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## I. Introduction

The foreign exchange market is a mammoth trading industry which significantly affects the international economy. Each day, banks, institutional investors, speculators, and the general public trade trillions of dollars in currency.[1] These transactions, either by exchange of currency or trading in "derivatives,"[2] help determine foreign exchange rates and shape the world economy. In the United States, government officials have scrutinized the regulation of foreign currency trading and the derivative market's effect on the nation's economy.[3]

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[1] Accurate data on the aggregate daily exchange of foreign currency is unavailable. Estimates range from many billions to many trillions of dollars. One part of this market is the New York Clearing House Interbank Payments System. In July 1993, an average of $1.087 trillion in dollar-based transactions moved through the system each day. Jay Mathews, *Putting Currency Trading on Trial*, WASH. POST, Aug. 22, 1993, at H1.

[2] A "derivative" is any financial product sold on the basis of an underlying "spot asset." For example, if a trader purchases an option to buy foreign currency, the market has "derived" and made available the option based on the underlying spot asset - the currency. *See* ALAN L. TUCKER, FINANCIAL FUTURES, OPTIONS, AND SWAPS 1 (1991).

[3] *See generally* Mathews, *supra* note 1. Representative Gonzalez (D–Tex.) has scrutinized the actions of individual traders, expressing concern about the lack of regulation of the massive foreign currency market. Gonzalez has also questioned whether an individual trader could significantly affect the foreign currency market. *Id.*

George Soros provides the most prominent example of how individual traders affect the foreign exchange market. In the summer of 1993, the European Rate Mechanism (ERM) experienced difficulties in reconciling member nation's currencies. When Soros abandoned an earlier promise to abstain from trading in the French franc, $9 billion in investment funds were unleashed on the franc. Although the trading by Soros did not doom the ERM, his entrance into the market stirred speculation on the currency. *See Financier Soros Adds to Pressure on European Exchange Rate System*, L.A. TIMES, July 31, 1993, at D1.

Currency futures[4] and options[5] in the United States are subject to federal law under the Commodity Exchange Act (CEA),[6] and the future and options markets are regulated by the Commodity Futures Trading Commission (CFTC). The CEA establishes a "contract-market monopoly" on all commodity futures and options by requiring these contracts to be traded on an organized exchange (a "contract market") which has been authorized by the CFTC.[7] Transactions not conducted on an approved market are prohibited.[8] Because foreign currency is defined as a commodity under the Act,[9] all futures and options in foreign currency must be conducted on a contract market.

Banks and institutions are exempt from the CEA.[10] The "Treasury Amendment"[11] exempts transactions in foreign currency when the transactions are conducted over the counter.[12] According to the legislative history of the CEA, the Treasury Amendment exempts the "interbank market," an informal network of institutions and their dealers which conduct their own trading in foreign currencies.[13] Because bank regulators monitor the activity of these institutions, CFTC oversight is unnecessary. Participants in the interbank market may trade options and futures over the counter, unrestricted by the contract-market monopoly.

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4 A "future" is a formalized "forward contract." A forward contract is formed when parties agree on a present price for the future delivery of the spot asset. *See* TUCKER, *supra* note 2, at 4-5. For example, a farmer forms a contract with a supplier to sell a bushel of wheat at a negotiated price, delivery to be taken in three months.

Futures are identical to forward contracts, except that the prices and terms of the agreements are standardized. This standardization increases the liquidity of the contracts and improves the pricing function of the market.

5 An "option" is a contract between two parties which gives the purchaser the right, but not the obligation, to purchase the spot asset at a later date. *Id.* at 5. For example, a person who wishes to buy a house but fears fluctuating market conditions could lock the seller in to a fixed price by paying, for example, $1,000 to the seller to hold his offer open for one month. This basic scheme of trading is applied to a myriad of spot assets, including foreign currency, where the cost of the option is cheaper than the risk of market conditions.

6 *See* 7 U.S.C. §§ 1-26 (1988 & Supp. IV 1992). The CEA originated in the 1920s as an attempt to curb speculation prevalent in the commodities futures industry. In order to limit commodity futures trading to markets which the government could regulate, the CEA created the "contract-market monopoly." *See infra* notes 96-102, 114-16 and accompanying text.

7 7 U.S.C. §§ 2a, 6(a)(1) (1988 & Supp. IV 1992).

8 *Id.*

9 7 U.S.C. § 1a(3) (Supp. IV 1992). The definition entails "all services, rights, and interests," which includes foreign currency. *See infra* notes 127-28 and accompanying text.

10 7 U.S.C. § 2(ii) (Supp. IV 1992).

11 Section 2(ii) has been termed the "Treasury Amendment" because the Department of Treasury wrote the language adopted by Congress. *See infra* note 141 and accompanying text.

12 7 U.S.C. § 2(ii) (Supp. IV 1992). Although this section allows over-the-counter trading without regulation, any transaction conducted on an approved contract market must comply with CFTC rules. An over-the-counter trade is a transaction which is conducted off an organized exchange. *See* JOHN F. MARSHALL, FUTURES AND OPTIONS CONTRACTING 5-6 (1989).

13 *See* S. REP. No. 1131, 93d Cong., 2d Sess. 49-51 (1974), *reprinted in* 1974 U.S.C.C.A.N. 5843, 5887-89 [hereinafter Treasury Letter].

Recently, the Fourth Circuit Court of Appeals addressed foreign currency trading regulation under the CEA and the Treasury Amendment. In *Salomon Forex, Inc. v. Tauber*,[14] a large trading company sued an individual trader for breach of contract concerning sixty-eight foreign currency futures and options. Tauber, the individual trader, claimed that his trades with Salomon were illegal. Because Tauber, an individual, traded futures and options over the counter, the contracts violated the contract-market monopoly and were unenforceable due to illegality. The court of appeals disagreed, holding Tauber liable for his trading debt.[15] Most significantly, the court held that the Treasury Amendment included "sophisticated traders" as part of the interbank market. Individuals who participate in the interbank market, if sophisticated, are exempt from the CEA.[16]

This Note will examine *Tauber's* effect on commodities regulation and trading in foreign currency. In Part II, the Note explains the background law, specifically the history and scope of the CEA and the Treasury Amendment. Part III explains fundamental economic concepts underlying the importance of the case. Part IV explores the intricacies of the case and the court's holding. In Part V, the Note compares *Tauber* to established law and examines the potential effects of the ruling. Finally, this Note concludes that *Tauber* presents a novel but potentially disruptive approach to commodities futures regulation because the holding permits a class of sophisticated traders, who are subject to no federal oversight, to trade over the counter.

## II. Statement of the Case

### A. *Facts*

Lazlo N. Tauber is a doctor, a real estate investor, and an active participant in foreign currency exchange.[17] He owns a trading company which specializes in foreign currency transactions, and his net worth is estimated at $500 million.[18]

Tauber began trading foreign currency in 1981. Individually and through his trading company,[19] Tauber exchanged billions of dollars in currency with at least fourteen trading companies.[20] Among these was Salomon Forex, Inc., a large foreign exchange company with of-

[14] 8 F.3d 966 (4th Cir. 1993), *cert. denied*, 62 U.S.L.W. 3575 (U.S. Apr. 18, 1994) (No. 93-1314) [hereinafter Tauber II].

[15] *Id.* at 979-80.

[16] *Id.* at 977-78.

[17] Salomon Forex, Inc. v. Tauber, 795 F. Supp. 768, 769 (E.D. Va. 1993), *aff'd*, Salomon Forex, Inc. v. Tauber, 8 F.3d 966 (4th Cir. 1993), *cert. denied*, 62 U.S.L.W. 3575 (U.S. Apr. 18, 1994) (No. 93-1314) [hereinafter Tauber I].

[18] *Id.* at 769-70.

[19] Tauber owns 75% of Westwood Options, Inc. This company holds a seat on the Philadelphia Stock Exchange, the nation's largest foreign currency exchange. *Id.* at 770.

[20] *Id.*

fices worldwide.[21] Tauber traded billions of dollars worth of currency with Salomon between 1987 and 1991.[22] Tauber and Salomon traded mainly in foreign currency futures and options, and these trades were primarily over the counter.[23] In all, Tauber and Salomon formed over 2,700 contracts for foreign currency.

Tauber's approach to trading prompted the district court to designate Tauber a "sophisticated foreign currency trader."[24] Tauber approached his trading strictly as an investor. He continually monitored the trades on a computer network designed to track exchange rates. He maintained foreign bank accounts which he used to trade. Instead of receiving the currency, he would "offset" the transactions.[25] Tauber was Salomon's only non-institutional client during the trading period.

Tauber's trading turned sour in March 1991. His investments declined in value, and Salomon demanded that Tauber cover the transactions.[26] Tauber's bill for sixty-eight trades totaled nearly $26 million.[27] When Tauber refused to pay, Salomon sued for breach of contract.

Tauber's chief defense was the illegality of the contracts due to violation of the CEA.[28] Tauber's argument was twofold: (1) Under the Treasury Amendment, "transactions in" foreign currency included only forward contracts, not futures and options;[29] and (2) Tauber, an individual, could not be exempt by the Treasury Amendment because the amendment exempts only institutions.[30] Because the futures and options between Tauber and Salomon were over the counter, and neither the contracts nor Tauber qualified for the Treasury Amendment exemption, the contracts were unenforceable due to illegality.

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21 *Id.*

22 *Id.*

23 *Id.*

24 *Id.*

25 "Offsetting" is a common practice in the futures industry. To offset, a trader will sell a second identical contract in the opposite position of his original purchase. The two contracts cancel each other out, netting zero for the trade. By offsetting, the trader avoids the necessity to take delivery of the underlying spot asset. He does so by satisfying the future delivery obligation with a counter-transaction. *See* PHILIP MCBRIDE JOHNSON & THOMAS LEE HAZEN, COMMODITIES REGULATION § 1.04 (2d ed. 1989).

26 *Tauber I*, 795 F. Supp. at 771.

27 Originally, Tauber owed approximately $30 million. However, Salomon used Tauber's collateral to satisfy $4 million of the debt. Because most of the collateral Tauber offered were letters of credit, Salomon could not reach the remainder of the debt. Tauber II, 8 F.3d 966, 970 (4th Cir. 1993).

28 *Tauber I*, 795 F. Supp. at 769 and n.2. Tauber responded with a number of affirmative defenses and counterclaims. Among these were fraud, duress, breach of fiduciary duty, estoppel, and negligence. The district court disposed of all but the CEA claim without written opinion.

29 *Id.* At trial, Tauber argued that options were "transactions *involving*" foreign currency. On appeal, Tauber expanded this argument to include futures. This argument was based on the idea that the Treasury Amendment exempts only transactions in the actual commodity, not futures and options based on the spot assets. *See infra* note 46 and accompanying text.

30 *Tauber I*, 795 F. Supp. at 769 and n.2.

### B. *District Court Holding*

On a motion for summary judgment, the district court held for Salomon. The decision hinged upon "whether certain foreign currency trading contracts are exempt from CEA regulation."[31]

The court reviewed the history of the CEA and analyzed the scope of the act, particularly the Treasury Amendment.[32] The court concluded that the CEA intended to include "virtually every good, article, right, or interest" as a commodity,[33] but Congress adopted the Treasury Amendment to exempt "transactions in foreign currency."[34] Interpreting the language of the Treasury Amendment, the court enumerated the principles of statutory interpretation[35] and concluded that the Treasury Amendment exempted Tauber's transactions from regulation. The court held that "the phrase 'transactions in foreign currency' plainly and unambiguously means any transaction . . . in which foreign currency is the commodity or subject matter."[36]

Tauber argued that the Treasury Amendment was applicable only to an informal network of banks and institutions (the interbank market).[37] Because these banks' and institutions' transactions in foreign currency are subject to banking regulations, the Treasury Amendment exempted them from the CEA.[38] Because the Treasury Amendment was adopted only to prevent dual regulation of the interbank market by the CFTC and bank regulators, individuals could not be included in the interbank market. The court rejected this reasoning, concluding that the Treasury Amendment was in no way restricted to the interbank market.[39] In its analysis, the court examined the history of the CEA and the Treasury Amendment, but refused to modify its statutory interpretation according to legislative history.[40] Because the court had concluded that " 'transactions in foreign currency' plainly and unambiguously" included futures and options, the legislative history that restricted the exemption to banks and institutions was irrelevant.[41]

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31 *Id.*

32 *Id.* at 771-73.

33 *Id.* at 772.

34 *Id.*

35 *Id.* at 773. The court began with the language of the statute. If this revealed Congressional intent, no further inquiry was warranted. The plain meaning of the statute would be rejected only if there was strong evidence of contrary Congressional intent. *Id.*

36 *Id.* Tauber challenged this broad construction of the Treasury Amendment, arguing that the phrase "transactions in" foreign currency did not include options on commodities. The district court disagreed. Once options are exercised, the trade becomes a "transaction in" foreign currency. *Id.*

37 *Id.*

38 *Id.* at 773-74.

39 *Id.* at 774.

40 *Id.* at 769-73.

41 *Id.* at 773. Compare the district court's analysis to the court of appeals' analysis which limited its holding to the interbank market. *See infra* notes 76-79 and accompanying text.

The district court's analysis drew sharp criticism from the CFTC. In a report on over-

An important aspect of the district court's analysis was its determination that Tauber was a sophisticated trader.[42] Citing his extensive trading, his ownership of a trading company, and his active participation in the trading, the court found that the record evidence supported its designation of Tauber as sophisticated.[43] This finding of fact was critical to the case. Although the district court broadly applied the Treasury Amendment exemption to all traders, the court of appeals limited the exemption to the interbank market. In doing so, the court of appeals adopted the district court's finding in its inclusion of the sophisticated trader in the interbank market.[44]

### C. *The Fourth Circuit's Decision*

On appeal, Tauber restated his argument.[45] First, the Treasury Amendment exemption of "transactions in" foreign currency excludes futures and options because these contracts, as derivatives, are "transactions *involving*" foreign currency.[46] Second, assuming futures and options were exempt, Tauber could not be a part of the "interbank market" that Congress intended to exempt because this market includes only banks and institutions.[47] Salomon argued that the Treasury Amendment is a broadly-worded exemption that applies to a broad range of over-the-counter transactions.[48] The court of appeals held for Salomon and affirmed the district court, but its analysis differed. The Fourth Circuit focused on the interpretation of "transactions in" foreign currency and the traders included in the interbank market.

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the-counter derivatives, the CFTC declared that "the district court went beyond the facts of the case before it by holding that *all* transactions in which foreign currency is the actual subject matter of an off-exchange contract for future delivery are excluded from the CEA under the Treasury Amendment." COMMODITY FUTURES TRADING COMMISSION, OTC DERIVATIVE MARKETS AND THEIR REGULATION 148 (Oct. 1993). In essence, the CFTC feared a broad reading of the decision would permit over-the-counter trading by any party. *Id.* at 150-51.

42 *Tauber I*, 795 F. Supp. at 770.

43 *Id.*

44 *See infra* note 79 and accompanying text.

45 Tauber II, 8 F.3d. 966, 978-79 (4th Cir. 1993). Tauber also appealed the district court's holding on three state law claims: a New York anti-bucket shop law violation, a negligence counterclaim, and a breach of covenant counter-claim. Although the court of appeals ruled on these issues, the holding is irrelevant to the CEA analysis. Therefore, this Note will not discuss these claims.

46 *Id.* at 973-74. Tauber expanded this aspect of his argument on appeal to include futures in addition to options. At trial, Tauber argued only for options to be excluded from "transactions in foreign currency."

47 *Id.*

48 *Id.* The court also explained the positions of the *amici curiae.* One side favored regulation in order to prevent the abuses Congress wished to avoid, while the other favored over-the-counter trading in order to improve or maintain market efficiency. In all, nine briefs were entered *amici curiae.* The groups included: the United States Department of Treasury, the Federal Reserve Bank of New York's Foreign Exchange Committee, the Futures Industry Association, and the Managed Futures Association (for Salomon); and the CFTC, the Board of Trade of Chicago, the State of Nevada, the State of Idaho, and the Chicago Mercantile Exchange (for Tauber). *Id.* at 974.

### 1. *Summary of the CEA and the Treasury Amendment*

In its construction of the language of the statute, the court examined which types of derivatives the Treasury Amendment exempts from regulation.[49] Tauber argued that "transactions in" foreign currency could not include futures and options; these contracts, as derivatives, are "transactions *involving*" foreign currency.[50] Thus, the phrase in the Treasury Amendment could only include spot transactions and forward contracts.

At the outset of its analysis, the court enumerated the principles of statutory construction. The court began with the words of the statute. If these words conclusively expressed Congressional intent, no further inquiry was warranted.[51] To gauge this intent, the court assumed that Congress used words reflecting its intent, that all words had a purpose and should be read consistently, and that "the statute's true meaning provides a rational response to the relevant situation."[52] The court presumed that any language added by amendment was not "surplusage," that undefined terms reflected the plain meaning of those words, and that the statute did not contradict itself.[53]

The court construed the phrase "transactions in foreign currency" logically, focusing on whether futures and options could be included in the language. The court concluded that "the phrase 'transactions in foreign currency' is broad and unqualified."[54] The breadth of the language was confirmed by the "unless" clause that followed. Logically applied, an "unless" clause must limit a broadly stated exception. As the court explained: "The class of transactions covered by the general clause 'transactions in foreign currency' must include a larger class than those removed from it by the 'unless' clause in order to give the latter clause meaning."[55] According to the court's analysis, "transactions in" foreign currency means *all* transactions—spot and derivatives—in the currency.

The court verified this interpretation by comparing the Treasury Amendment to other parts of the statute. First, the court cited section 1a(11) of the CEA, the "future delivery" definition.[56] This section excludes from the term "future delivery" all cash sales for future delivery

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49 *Id.* at 975-76.

50 *Id.* at 973.

51 *Id.* at 975.

52 *Id.* The court's meaning of this language is not clear. It appears that the court would read the statute as addressing the problem which Congress intended to legislate.

53 *Id.* Interestingly, the court cited no authority for its principles of statutory construction. However, its recitation of the law is consistent with, and closely echoes, Matala v. Consolidated Coal Co., 647 F.2d 427 (5th Cir. 1981). *Malta* was one of the primary cases upon which the district court relied for its interpretation. *See* Tauber I, 795 F. Supp. 768, 773 (E.D. Va. 1993).

54 *Tauber II*, 8 F.3d at 975.

55 *Id.*

56 7 U.S.C. § 1a(11) (Supp. IV 1992).

(i.e. forwards), and the section was in force before 1974.[57] When the Treasury Amendment was enacted in 1974, the CEA already excluded spots and forwards from coverage. Congress added the Treasury Amendment to exempt a *broader range* of contracts—specifically, futures and options.[58] Therefore, "transactions in" foreign currency must refer to the newly-exempted contracts.

In the second comparison, the court cited section 5 of the CEA.[59] This section refers to futures as "transactions in commodities."[60] As the court reasoned, given that Congress referred to futures as "transactions *in*" a commodity in Section 5, "transactions *in* foreign currency" must include futures whenever the language appears in the CEA.[61] From the two examples, the court reasoned that its interpretation of "transactions in foreign currency" as including futures was internally consistent with other parts of the CEA.

The court addressed Tauber's argument that the Treasury Amendment only exempted spots and forwards. The court rejected this argument, considering forwards identical to futures for analytical purposes.[62] As the court asked: "Why would a cash forward be analytically different from a future? Neither transaction involves contemporaneous delivery. Both transactions involve the purchase of a promise—a contract right—and only indirectly concern the underlying subject matter."[63] Reasoning that forwards and futures are sufficiently similar, the court decided that futures must be "transactions in foreign currency."[64]

Expanding its conclusion, the court summarily applied its futures analysis to all transactions in foreign currency, including options. According to the court, "there is no principled reason to distinguish between [futures and options] in this context."[65] Therefore, Tauber's trades in foreign currency options, like futures, are "transactions in" foreign currency. As the statute plainly states, these contracts are exempt from the CEA.

### 2. *Legislative History of the Treasury Amendment*

Having established that futures and options were excluded from CEA coverage, the court focused on the legislative history of the Treasury Amendment.[66] To determine whether the interbank market could include an individual trader, the court reframed the issue from *which*

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57 *Id.*
58 *Tauber II*, 8 F.3d at 975.
59 *Id.* at 976 (citing 7 U.S.C. § 5 (1988)).
60 7 U.S.C. § 5 (1988).
61 *Tauber II*, 8 F.3d at 976.
62 *Id.* at 975-76.
63 *Id.* at 975.
64 *Id.*
65 *Id.*
66 *Id.* at 976.

*transactions* are exempt from CEA coverage to *which participants in the market* are exempt.[67]

In response to Tauber's claim that only the banks and institutions were exempt from the CEA, the court analyzed Congressional intent regarding the interbank market. The court acknowledged that the Treasury Department was primarily concerned with the interbank market, but the participants in this market were not solely banks and institutions.[68] When the Treasury Department wrote to the Congressional committee about the interbank market, it referred to "an informal network of banks *and dealers*"[69] and expressed concern for "an adverse impact on the usefulness and efficiency of foreign exchange markets *for traders and investors*."[70] The court concluded that the true distinction was not, as Tauber argued, between banks and individuals.[71] The Treasury Letter instead distinguished between participants in the informal network and traders on organized exchanges.[72] The Treasury Amendment addressed the nature of the trade—whether it appeared on an organized exchange or over the counter; the "corporate form" of the trader was irrelevant to the inquiry.[73] Had Congress truly intended to exempt only banks, clear statutory language would have so declared.[74] Instead, the Treasury Amendment exempted "all trading off organized exchanges," including the interbank market.[75] Because the transactions at issue were between "sophisticated financial professionals," the Treasury Amendment exempted the contracts from the CEA.

The court qualified its broad holding.[76] Tauber argued that an interpretation exempting all transactions would allow circumvention of the CEA by anyone who traded over the counter.[77] The court decided that Tauber "misapprehended the issue which this case presents."[78] The court concluded that its holding does not apply to mass marketing of futures to the general public. Re-emphasizing the nature of its holding, the court stated that the Treasury Amendment exempts only sophisticated, large-scale foreign currency traders.[79] The

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67 It is important to note the chief difference between the court of appeals' and the district court's analyses. Where the Fourth Circuit qualified its analysis as inapplicable to mass marketing to the trading public, the district court broadly applied the Treasury Amendment exemption to all trading. *See supra* notes 39-41 and accompanying text.

68 *Tauber II*, 8 F.3d at 976. The correspondence between the Treasury Department and the Congressional committee is referred to as the Treasury Letter. *See supra* note 13.

69 *Tauber II*, 8 F.3d at 977 (quoting Treasury Letter, *supra* note 13, at 5887).

70 *Id.* (quoting Treasury Letter, *supra* note 13, at 5888).

71 *Id.*

72 *Id.*

73 *Id.*

74 *Id.*

75 *Id.*

76 *Id.* at 978.

77 *Id.*

78 *Id.*

79 *Id.* The court re-emphasized its holding in its response to Tauber's concern that the

general public must comply with the CFTC contract-market monopoly.

### 3. *The Case Law: Redefining the Issue*

In comparing authorities, the Fourth Circuit promoted its interpretation of the Treasury Amendment and the interbank market. The Seventh and Second Circuits had previously addressed the Treasury Amendment and its application to futures and options, but both cases involved trading by the general public on organized exchanges. The Fourth Circuit held that the cases did not apply to sophisticated financial traders trading off-exchange.[80] Although the court acknowledged that other circuits had interpreted the statute differently, it concluded that the authority did not apply to the facts in *Tauber* because those cases involved contract markets trading with the general public, not the interbank market.[81] From its brief review of the facts and holdings of the two cases, it appears that the Fourth Circuit addressed the case law as an afterthought; the court's chief emphasis was statutory interpretation.

## III. Economic Aspects of Foreign Currency Derivatives[82]

The foreign exchange market is perhaps the world's largest financial market. The participants include governments, banks, institutional investors, multinational corporations, financial speculators, and travelers who change their home currency to spend abroad. With its breadth and importance to so many market participants, the foreign exchange market touches every aspect of the world economy.

The holding in *Tauber* involves economic theories of the foreign exchange derivatives market. Understanding the basic premises of these theories is critical to appreciating the importance of the *Tauber* decision.

### A. *Fundamentals of Futures and Options*

Futures and options reduce the risks of buying or selling a commodity.[83] A trader who wishes to purchase a commodity in the future but fears increasing prices can reduce his exposure to price fluctuation by "hedging" his risk through the purchase of a future or option in the

Fourth Circuit would become a base for off-exchange trades: "This case does not involve mass marketing to small investors . . . and our holding in no way implies that such marketing is exempt from the CEA." *Id.*

[80] *Id.* at 977-78.

[81] *Id.* at 978. Perhaps the most revealing aspect of this part of the decision is the summary nature of the court's analysis of the case law. *See id.* at 977-78.

[82] This rudimentary recitation of economic principles in no way represents a thorough analysis. The purpose of this section of the Note is to present a context for the court's decision.

[83] *See* JOHN F. MARSHALL, FUTURES AND OPTIONS CONTRACTING 52-53 (1989).

commodity.[84] For example, a person intends to sell a commodity for use three months in the future but fears sharp drops in the price. She may protect against sharp drops in the price by purchasing a future contract for the commodity to be delivered in three months. The future contract guarantees a presently-agreed-upon price and eliminates the risk of falling prices. Thus, the person reduces (hedges) her risk of purchasing the commodity.

The hedger's risk of loss will not disappear, so another party must assume the risk which the hedger has foregone. Thus, a "speculator" will purchase a position opposite the hedger.[85] In the above example, the speculator will purchase a future contract assuming the price will rise. The speculator assumes the risk which the hedger has avoided. As compensation for this risk, the speculator will reap higher profits if his wager is correct. Thus, the hedger and the speculator complement each other's functions.

The interaction of these participants benefits commodity markets in two ways. First, their trading in futures (and options) aids the pricing mechanism of the market. Each time a hedger and speculator shift risk, the price of the derivative helps to determine a fair price for the underlying spot asset. Second, the interplay of supply and demand of derivatives between the hedger and the speculator reduces the costs of commodity contracting.[86] This increases liquidity and efficiency in the commodity markets. In short, trading in futures and options reduces risk for the hedger, increases profits for the speculator, and benefits the market as a whole.

### B. *Futures and Options in the Foreign Exchange Market*

#### 1. *Fluctuation of Exchange Rates and Use of Derivatives*

The foreign exchange market is a very volatile market which economists find hard to predict. Theories of the fluctuation of the exchange rates are based on relative purchasing power,[87] balance of payments between countries,[88] currency as an asset,[89] a reflection of interests rates and the supply of money,[90] and the "rational expectations" of purchasers of currency forwards.[91] Regardless of specific the-

[84] *Id.* at 53. The most basic hedging device is the forward contract which guarantees future delivery for a presently-agreed-upon price. However, the standardization of future prices often make these a more attractive alternative. *Id.* at 55.

[85] *See* TUCKER, *supra* note 2, at 137-39. A speculator has no real stake in the commodity. Instead, the speculator enters the market solely to profit from incurring risk. For a comparison of the commodity speculator to the security investor, see JOHNSON & HAZEN, *supra* note 25, § 1.14.

[86] *See* MARSHALL, *supra* note 83, at 55.

[87] NICK DOUCH, THE ECONOMICS OF FOREIGN EXCHANGE 3 (1989).

[88] *Id.* at 13.

[89] *Id.* at 23.

[90] *Id.* at 29.

[91] *Id.* at 37.

ories, exchange rates are relative prices of money influenced by financial, economic, and political factors.[92]

Despite the wealth of economic theories, exchange rates are difficult, often impossible, to predict.[93] If a market participant intends to deal overseas, monetary flows can result in substantial losses if the exchange rates are improperly predicted. A trader in foreign currencies will seek stability and predictability in the face of such risk.

In the foreign exchange market, as in any spot asset market, futures and options reduce risk in trading and stabilize the market. Financial planners, as hedgers, purchase futures and options to reduce risk, and market participants, as speculators, profit from the use of derivatives by hedgers. The result is a reduction in currency risk with an accompanying profit from financial speculation.

### 2. *Users of Foreign Currency Derivatives*

Banks, investors, and multinational corporations use foreign currency derivatives in varying degrees. Each entity will use a derivative either to minimize business and investment risk or to speculate.

As an example of a corporation, an American manufacturer proposes to export its products to Germany. The purchase will take place in three months' time, and the corporation will take Deutschmarks (DMs) as payment. If the dollar rises against the DM, profits will be eroded. Therefore, concern over volatile interest rates[94] causes worry within the corporation. As a hedge against the devaluation of the Deutschmark, the company purchases a future contract on American dollars against the German currency. This future locks in a current price for future delivery and protects against a strong dollar. In other words, the company knows it will receive a constant rate against the DM, and its profits will be predictable. Thus, the corporation has "hedged" its risk and ensured that its profits will remain relatively high against the dollar when received in DM.

Another example of users of foreign currency derivatives are institutional investors. Here, the investor (a mutual fund or pension fund) can hedge risks when purchasing equity in foreign corporations. For example, if a U.S. mutual fund chooses to invest in a foreign corporation, a strong dollar could devalue their equity investment. Therefore,

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92 *Id.* at 29.

93 *See generally* Bluford H. Putnam, *The Science and Art of Forecasting Exchange Rates, in* FOREIGN EXCHANGE: FUNCTIONS, LIMITS, AND RISKS 140 (Jackie Whitley ed., 1992).

94 The effect of interest rates on exchange rates was graphically illustrated on February 4, 1994. When the Federal Reserve Board (Fed) Chairman announced a .25% increase in short-term interest rates, the dollar surged against foreign currencies. The J.P. Morgan Index , a composite of the dollar's performance against nineteen foreign currencies, rose .5%. *U.S. Dollar,* WALL ST. J., Feb. 7, 1994, at C1. The move by the Fed kicked off a wave of speculation on the dollar despite currency analysts' belief that the dollar would not strengthen against foreign currencies. Gene Cotler, *Move by Fed Puts Dollar in Limelight, Prompts Round of Speculative Buying,* WALL. ST. J., Feb. 7, 1994, at C15.

the fund can hedge against such risk by purchasing a future on the foreign currency, assuring a single price and limiting the risks of currency fluctuation.[95]

A third user of foreign currency derivatives is the consumer of investment information. As discussed above, derivatives provide up-to-date information on the price of the underlying spot assets. Therefore, all participants in the foreign exchange market benefit from the pricing function of foreign currency derivatives.

## IV. Commodity Futures Regulation Under the CEA

### A. *The Commodity Exchange Act*

#### 1. *A Short History of Commodities Regulation*

The CEA originated in the 1920s as an effort to stem the tide of "bucket shops" and other speculative abuses.[96] Following decades of populist sentiment against financial manipulation of agricultural products,[97] Congress in 1921 passed the Futures Trading Act.[98] Recognizing the benefits of legitimate futures trading in agricultural products,[99] Congress focused on abusive practices. The Futures Trading Act was later renamed the Grain Futures Act,[100] then the Commodity Exchange Act (CEA).[101] The fundamental concept underlying the CEA

[95] *See* Carolyn Sykes, *Strategic Currency Management in Foreign Equity Portfolios, in* FOREIGN EXCHANGE: FUNCTIONS, LIMITS, AND RISKS 110 (Jackie Whitley ed., 1992).

[96] A "bucket shop" was a trading establishment where customers could gamble on the exchange prices without reporting the transaction to a board of trade. The shop would assume the risks of net positions by offsetting the bets against its funds. If the customers won big against the shop, however, the shop would pack up and take the funds, leaving the customers holding worthless futures. *See* JERRY W. MARKHAM, THE HISTORY OF COMMODITY FUTURES TRADING AND ITS REGULATION 9-10 (1987). Aside from the bucket shops, Congress' chief concern was the bald manipulation that was prevalent in commodity trading. *See* William L. Stein, *The Exchange-Trading Requirement of the Commodity Exchange Act*, 41 VAND. L. REV. 473, 477 (1988).

[97] The populist movement, backed by the power of the farmers and the oratory of their representatives, was a strong (and colorful) movement against financial innovation. As one author reports: "Senator Capper further charged that the Chicago Board of Trade was a 'gambling hell,' that it was the 'world's greatest gambling house': 'Monte Carlo or the Casino at Habana are not to be compared with it.' " MARKHAM, *supra* note 96, at 13.

[98] Futures Trading Act of 1921, Pub. L. No. 67-66, 42 Stat. 187.

[99] *See* Stein, *supra* note 96, at 477. The economic benefits of commodity derivatives are discussed *supra* notes 83-95 and accompanying text.

[100] In 1922, the Supreme Court held the Futures Trading Act unconstitutional as an overreaching of Congress' taxing power. Hill v. Wallace, 259 U.S. 44 (1922). However, Congress reacted immediately and passed the Grain Futures Act, based on its power under the Commerce Clause. The new law was essentially the same, and its constitutionality was later upheld. Board of Trade of Chicago v. Olsen, 262 U.S. 1 (1923).

[101] In 1936, Congress revised the Grain Futures Act and renamed it the Commodity Exchange Act. The Great Depression ruined the commodities markets. Furthermore, speculators flooded into the less-regulated commodities markets after the Securities Exchange Act of 1934 deterred speculation in securities. In response, Congress moved to stem increased speculation in commodities. Thus, the CEA created a new administration within the Department of Agriculture to monitor the contract markets and foster "self-regulation." *See* MARKHAM, *supra* note 96, at 24-28.

was the restriction of futures trading to government-approved contract markets and an accompanying ban on all futures trading not conducted on such a market.[102]

From its inception until the early 1970s, the CEA was administered by the Department of Agriculture, regulating chiefly commodities found on the farm,[103] but in the 1960s, a number of problems arose. As the commodity futures industry developed, commodities, such as sugar, which fell outside the scope of the CEA, became the subjects of speculation.[104] Self-regulation of the contract markets began to fail,[105] and futures were becoming increasingly critical to pricing of the underlying commodity.[106] The need to revise the CEA became apparent as more and more problems fell beyond the reach of the statute.

Responding to these problems as well as substantial public pressure,[107] Congress greatly revised the CEA in 1974 with the passage of the Commodity Futures Trading Commission Act (CFTCA).[108] This act was a comprehensive revamping of the CEA. The most important change was the creation of the Commodity Futures Trading Commission, the independent regulatory agency charged with supervision of the contract markets. The 1974 amendments granted this new agency exclusive jurisdiction over commodity futures and options.[109] Two other important changes were the expansion of the definition of a "commodity,"[110] and at the suggestion of the Department of Treasury, the adoption of a provision addressing the interbank trading of foreign currencies and other instruments.[111]

Since 1974, the CEA has undergone a number of changes, the most significant of which was the 1982 Congressional action to resolve a jurisdictional conflict between the CFTC and the SEC.[112] Currently, the CFTC has jurisdiction over all futures and options sold on commodities.[113]

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102 67 CONG. REC. H1318 (daily ed. May 11, 1921).

103 *See* MARKHAM, *supra* note 96, at 35-47.

104 *Id.* at 50-52.

105 *Id.* at 62.

106 *Id.* at 60-61.

107 As an example of public sentiment, in 1973, the *Des Moines Register* published a series of articles which greatly criticized the commodities industry. Chiefly, the articles criticized a lack of control in the industries and alleged rigging of prices. *Id.* at 58-59.

108 Commodity Futures Trading Commission Act, Pub. L. No. 93-463, 88 Stat. 1389 (codified as amended at 7 U.S.C. §§ 1-26 (1988 & Supp. IV 1992)).

109 *See* 7 U.S.C. § 2(ii) (Supp. IV 1992).

110 This definition greatly expanded the scope of the CEA by including a list of agricultural products and "all services, rights, and interests" as commodities. 7 U.S.C. § 1a(3) (Supp. IV 1992). *See infra* notes 127-28 and accompanying text.

111 Codified at 7 U.S.C. § 2(ii) (Supp. IV 1992) (this later became known as the Treasury Amendment).

112 Futures Trading Act of 1982, Pub. L. No. 97-444, 96 Stat. 2294 (codified as amended at 7 U.S.C. § 2 (1988 & Supp. IV 1992)).

113 The definition of a "commodity" has often reached beyond the definitions section of

### 2. *Scope of the CEA: The Contract-Market Monopoly*

#### a. *Regulation of Futures and Options*

##### i. *Section 4: Broad Prohibition of Off-Market Futures*

The essence of the CEA is its broad prohibition of trading of over-the-counter commodity futures contracts.[114] To enforce this ban, the CEA requires all futures trading be conducted on CFTC-authorized exchanges. The effect is a regulatory monopoly of contract markets by the federal government.

Section 4 of the CEA prohibits any person from offering, contracting, or dealing in "a contract for the purchase or sale of a commodity for future delivery . . . unless - (1) such transaction is conducted on or subject to the rules of a board of trade which has been designated by the Commission as a 'contract market' for such commodity."[115] Thus, all trades must be conducted on a CFTC-designated contract market. The CFTC approves these markets, then periodically monitors their trading practices.[116] By prohibiting commodity futures trading by any means other than those approved by the Commission, the CEA subjects all trading to CFTC regulations.

##### ii. *Exception of Deferred Delivery*

The CEA regulates primarily futures, which are standardized and traded for investment purposes. By contrast, the forward contract market involves individually-negotiated contracts where the parties primarily intend to trade in the underlying commodity. From its inception, the CEA targeted only futures markets.[117] Therefore, the CEA's definition of "contract for future delivery" (i.e. futures) excludes those transactions in which the parties anticipate actual delivery.[118] Because of this exclusion, forwards are not "contract[s] for the purchase or sale of a commodity for future delivery."[119] As the CFTC has stated:

> Congress intended to permit only: 1) those futures transactions which were executed through the facilities of the designated contract market, markets regulated by the federal government, which were required, in turn, to regulate the activities of their members; and 2) cash

the CFTC. The creation of "hybrid" instruments has required creative regulation by the CFTC. *See generally* Jerry W. Markham, *Regulation of Hybrid Instruments Under the Commodity Exchange Act: A Call for Alternatives*, 1990 COLUM. BUS. L. REV. 1 (1990). The courts have wrestled with the definitions of commodities and securities regarding hybrid instruments. *See* Chicago Mercantile Exch. v. SEC, 883 F.2d 537 (7th Cir. 1987).

[114] *See* Stein, *supra* note 96, at 477.

[115] 7 U.S.C. § 6(a)(1) (1988). Subsection (2) of this section requires the contract to be executed by a member of the market, and subsection (3) requires the contract to be evidenced in writing.

[116] *See infra* notes 129-36 and accompanying text.

[117] *See* MARKHAM, *supra* note 96, at 12-13.

[118] 7 U.S.C. § 1a(11) (Supp. IV 1992).

[119] 7 U.S.C. § 6 (1988 & Supp. IV 1992).

commodity transactions for deferred shipment or delivery.[120]

Without this provision, the CFTC would regulate *all* transactions where the parties agreed to a present sale and a future delivery. Forward contracts are beyond Congress' concern, and the CEA leaves this market untouched.[121]

### iii. *The Options Restriction*

The preceding sections discussed the CEA's treatment of futures and forwards. The CEA has also adopted special rules for options trading.

Abuses of commodity options prompted the CFTC to ban all such trading in 1978.[122] Later, Congress codified this ban. Section 4c of the CEA prohibits all option trading in commodities unless authorized by CFTC rules.[123]

In 1982, Congress instructed the CFTC to initiate a pilot program to allow commodity option trading on the contract markets.[124] Congress approved the program in 1986 and ordered the CFTC to end the pilot status of the program.[125] In 1987, the CFTC amended its rules to allow trading on the contract markets.[126]

This scheme of regulation for option trading parallels futures trading regulation. As long as the trade is executed on a CFTC-approved contract market, CFTC rules for the exchanges apply; otherwise, the trade is prohibited.

### iv. *Broad Definition of "Commodity"*

The breadth of the CEA is evident in its expansive definition of a commodity; the definition section of the act fortifies the contract-market monopoly by extending the CEA to a vast array of commodities. Prior to 1974, the definition of a commodity was fairly narrow, but the CFTCA greatly expanded the definition to include nearly all agricultural products[127] and "all other goods and articles . . . and all services, rights, and interests."[128]

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120 *In re* Stovall, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941, at 23,781 (C.F.T.C. Dec. 6, 1979). This statement was specific to the case and failed to mention the other primary exception to CFTC regulations: the spot transaction.

121 Another type of contract which the CEA does not regulate is the spot contract where parties exchange a commodity for present sale.

122 17 C.F.R. § 32.11 (1978). This general ban contained certain exceptions not relevant to the discussion.

123 7 U.S.C. § 6c (1988 & Supp. IV 1992).

124 Futures Trading Act of 1982, Pub. L. No. 97-444 (codified at 7 U.S.C. § 6c(c) (1982)).

125 Futures Trading Act of 1986, Pub. L. No. 99-641 (codified at 7 U.S.C. § 6c(c) (Supp. IV 1992)).

126 17 C.F.R. § 32.1(a) (1993).

127 The statute contains a grocery list of specific products, from wool tops to Irish potatoes. 7 U.S.C. § 1a(5) (Supp. IV 1992).

128 *Id.*

The importance of this definition is twofold. First, it expanded the definition to include certain agricultural products which had been the target of market crashes in the 1960s. Second, and most important, the new definition included a broad range of financial instruments not previously subject to CEA jurisdiction.

*b. CFTC Enforcement Mechanisms*

In order to enforce the contract-market monopoly, the CFTC is granted exclusive jurisdiction over futures trading.[129] The commission can designate contract markets,[130] register participants in the markets,[131] and receive complaints about registrants.[132] Furthermore, the CFTC may suspend the designation of a contract market,[133] suspend an individual's privilege of trading on a market,[134] and assess monetary penalties for violations of the Act.[135] In short, Congress has granted the CFTC wide enforcement authority to compel compliance with the CEA.[136]

*B. The Treasury Amendment*

An important exception to the contract-market monopoly is the so-called "Treasury Amendment" that reads:

> Nothing in this Act shall be deemed to govern or in any way be applicable to transactions in foreign currency, security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments, unless such transactions involve the sale thereof for future delivery conducted on a board of trade.[137]

The Treasury Amendment allows over-the-counter trading of a range of financial instruments by exempting these transactions from the contract-market monopoly. However, the administrative comments and the litigation in the two decades since the Amendment's enactment indicate that it has not been accepted as a clear statement of the law.[138]

To understand the Amendment, one must explore its origins.

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129 *Id.* § 2.

130 7 U.S.C. § 2a (1988). This designation is subject to minimum requirements enumerated in the section.

131 7 U.S.C. § 12a(1) (Supp. IV 1992). These "participants" include merchants, brokers, advisors, and a number of other participants in the markets.

132 7 U.S.C. § 18 (1988 & Supp. IV 1992).

133 7 U.S.C. § 7b (Supp. IV 1992).

134 *Id.* § 9.

135 *Id.* § 9a. The enumerated powers are just a few means by which the CFTC may enforce the statute.

136 *Id.* § 15. The CFTC Division of Enforcement is charged with compelling compliance by initiating actions. For a brief summary of the division's powers and duties, see JOHNSON & HAZEN, *supra* note 25, § 4.12.

137 7 U.S.C. § 2(ii) (Supp. IV 1992).

138 *See generally* CFTC v. American Bd. of Trade, 803 F.2d 1243 (2d Cir. 1986); Board of Trade of Chicago v. SEC, 677 F.2d 1137 (7th Cir. 1982); CFTC and State of Ga. v. Sterling

When the Congressional Committee on Agriculture and Forestry considered amending the CEA in 1974, the Department of Treasury opposed the potential scope and lack of clarity of the proposed amendments.[139] Primarily, the Treasury Department feared an overlap of the banking and commodity regulations.[140] Accordingly, the Department of Treasury wrote a letter to the Congressional committee considering the CFTCA to express its concerns and suggest alternatives.[141]

The Treasury Letter addressed trading in foreign currency by banks and institutions.[142] A large interbank market of foreign currency traders existed.[143] This market, already subject to banking regulations,[144] required no additional federal oversight. As the letter explained,

> Virtually all futures trading in foreign currencies in the United States is carried out through an informal network of banks and dealers. This dealer market, which consists primarily of the large banks, has proved highly efficient in serving the needs of international business in hedging the risks that stem from foreign exchange rate movements. The participants in this market are sophisticated and informed institutions, unlike the participants in the *organized* exchanges, which, in some cases, include individuals and small investors who may need to be protected by some form of governmental regulation.[145]

When the Treasury Department notified Congress of the potential over-regulation of the interbank market, Congress responded by adopting the Treasury Amendment, taken nearly verbatim from the letter.

The scope of the Treasury Amendment is ambiguous, and it is arguable whether it applies to individual traders who participate in the interbank market. Although the letter clearly states that "foreign currency futures trading, other than on organized exchanges, should not be regulated by the [CFTC],"[146] the letter repeatedly expresses concern for "banks and other institutions."[147] Reading the language of the statute, a court could conclude that the exemption applies to one of two categories of traders: (1) institutions only or (2) a broad range of participants in the market, individual or institutional.

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Capital Co., [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,169, at 24,783 (N.D. Ga. 1981).

139 Treasury Letter, *supra* note 13, at 5887.

140 *Id.*

141 Treasury Letter, *supra* note 13.

142 *Id.*

143 *Id.*

144 The institutional participants in the interbank market are generally subject to federal banking regulations. *See generally* 12 C.F.R. §§ 347, 351 (1993); 31 C.F.R. §§ 103, 128 (1993).

145 Treasury Letter, *supra* note 13, at 5888.

146 *Id.* at 5887.

147 *Id.*

### C. *The Case Law Interpretation of the Treasury Amendment*

Judicial interpretation of the Treasury Amendment is limited. Prior to *Tauber*, only the Second and Seventh Circuits had interpreted the amendment,[148] and neither had closely examined its application to the interbank market.

The Seventh Circuit was the first court of appeals to interpret the Treasury Amendment. In *Board of Trade v. SEC*,[149] the court addressed the trading of options on Government National Mortgage Association mortgage-backed certificates (Ginnie Maes). Essentially, a jurisdictional dispute between the SEC and the CFTC arose in the late 1970s,[150] and *Board of Trade* brought the issue to light.[151] The Chicago Board of Options Exchange (CBOE) sought and received SEC approval for a modification of its exchange rules to allow options trading on Ginnie Maes on the CBOE. The Board of Trade of the City of Chicago sued[152] claiming that the SEC lacked jurisdiction over the rule approval.[153]

The CBOE argued that the Treasury Amendment, by exempting "transactions in . . . government securities," placed the exchange trading beyond CFTC jurisdiction. The Seventh Circuit rejected this argument holding that an option in a commodity could not be a "transaction *in*" that commodity if the option were not exercised. If, however, the holder of the option exercises his right to purchase, the sale becomes a transaction in that commodity.[154] Because the options traded on the CBOE were purchased for investment and never executed, the contracts could not be "transactions in" Ginnie Maes.

The court explained its holding in light of the Treasury Amendment's exclusion of banks and institutions. As the court stated, "from the legislative history, it is quite clear that the Treasury [A]mendment was adopted by Congress only to prevent dual regulation by the CFTC and bank regulatory agencies of the banks and other sophisticated institutions that ordinarily trade in the enumerated financial instru-

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148 A number of district courts have examined the Treasury Amendment. *See, e.g.*, CFTC and State of Ga. v. Sterling Capital Co., [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,169, at 24,783 (N.D. Ga. 1981). Some of these cases are cited in the circuit court opinions, and the appellate courts generally followed the analyses of those cases.

149 677 F.2d 1137 (7th Cir. 1982), *vacated as moot*, 459 U.S. 1026 (1982). *Board of Trade* was vacated by the Supreme Court due to Congress' amendment of the CEA in 1982 to resolve the jurisdictional dispute between the SEC and the CFTC.

150 *See* JOHNSON & HAZEN, *supra* note 25, § 4.25.

151 The chief issue in the case was which regulatory agency had jurisdiction over options on Ginnie Maes, as they are both "commodities" and "securities." *Board of Trade*, 677 F.2d at 1138.

152 The Board of Trade's interest in the suit was its active trading of futures on Ginnie Maes. Futures and options serve primarily the same purposes, and the instruments often compete for investors. *Id.* at 1140. Thus, the Board of Trade sought uniform rules for the trading of the instruments. *Id.*

153 *Id.*

154 *Id.* at 1154.

ments."[155] The Seventh Circuit concluded that the Treasury Amendment exemption applied to banks and institutions,[156] but the court did not address individuals who participate in the interbank market. The holding in *Board of Trade*, that options are not "transactions in" a commodity unless exercised, did not reach the issue of an individual who trades as part of the interbank market.

The Second Circuit interpreted the Treasury Amendment four years later. In *CFTC v. American Board of Trade*,[157] the CFTC sued to enjoin the American Board of Trade from offering a marketplace for commodities to the general public because the market had not been approved by the CFTC.[158]

The defendants sought the Treasury Amendment's exemption of "transactions in" foreign currency by arguing that options should be excluded under this phrase. In response, the court echoed the Seventh Circuit's holding: an option is not a "transaction in" a commodity unless the option is exercised.[159]

The Second Circuit explained its holding in light of the purposes of the Treasury Amendment. After explaining the origin of the Treasury Amendment, the court concluded that the defendants illegally opened a contract market. By arguing that the Treasury Amendment exempted all transactions in foreign currency, the defendants misconstrued the scope of the exemption. Their argument belied "the notion that the exception was designed to exclude from regulation foreign currency options transactions such as those defendants engaged in *with private individuals*."[160] The interbank market was the limit of the exemption.

The last clause of the quoted portion of *American Board of Trade* reflects an important similarity in the Seventh and Second Circuit decisions. In both cases, the courts interpreted the Treasury Amendment exemption where the issue was a board of trade dealing with the general public. In neither case did the court reach the issue of an individual as a member of the interbank market.

### D. *The CFTC and the Treasury Amendment*

The CFTC has consistently applied its regulatory power as expansively as possible. Charged with exclusive jurisdiction over futures and options trading, the CFTC has viewed the Treasury Amendment as a narrow exemption to its broad oversight powers. Specifically, the

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155 *Id.*

156 *Id.* at 1154.

157 803 F.2d 1242 (2d Cir. 1986).

158 *Id.* at 1244.

159 *Id.* at 1248 (citing *Board of Trade*).

160 *Id.* at 1249 (emphasis added).

CFTC has interpreted the Treasury Amendment to exempt only *institutional* traders already subject to banking regulations.

In a 1985 notice,[161] the CFTC explained that the Treasury Amendment exemption applied only "when such transactions are entered into by and between banks and certain other sophisticated and informed institutional participants."[162] In litigation, the CFTC has consistently argued that the exemption applies only to institutional investors.[163] In no opinion has the CFTC embraced the notion of an individual as a participant in the interbank market.

## V. The Fourth Circuit's Interpretation and the "Sophisticated Trader"

### A. *The Fourth Circuit's Construction of the Law*

Two critical issues arise regarding interpretation of the Treasury Amendment. First, can the language "transactions in foreign currency" be read to exclude futures and options from regulation? Second, does the legislative history permit the conclusion that individuals who could reasonably be considered "sophisticated traders" are entitled to the exemption?[164]

#### 1. *Interpretation of "Transactions In" Foreign Currency*

The most striking aspect of the court's interpretation of the statute is the rigorous analysis of the words used by Congress. Of the courts which have interpreted the statute, only the Fourth Circuit has so thoroughly scrutinized the language of the Treasury Amendment. In its interpretation, the court followed its enumerated principles of statutory construction,[165] and relied solely on the words used by Congress to determine which contracts the CEA regulates. The court concluded that "under the appropriate interpretation of the Treasury Amendment, all off-exchange transactions in foreign currency, including futures and options, are exempted from regulation."[166]

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161 Trading in Foreign Currency for Future Delivery, 50 Fed. Reg. 42,983 (1985).

162 *Id.* at 42,984.

163 *See generally* Tauber II, 8 F.3d 966 (4th Cir. 1993); CFTC v. American Bd. of Trade, 803 F.2d 1242 (2d Cir. 1986); Tauber I, 795 F. Supp. 768 (E.D. Va. 1993); CFTC and State of Ga. v. Sterling Capital Co., [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,169, at 24,783 (N.D. Ga. 1981); CFTC v. Standard Forex, No. CV-93-0088 (S.D.N.Y. Aug. 9, 1993).

This strict view of the scope of the Treasury Amendment may be moderated in a recent CFTC opinion. In a report of October 1993, the CFTC expressed its view that "the Treasury Amendment does not extend to the sale of futures obligations to the general public." COMMODITY FUTURES TRADING COMMISSION, *supra* note 41, at 155. In this report, the CFTC did not address its prior assertion of *institutional* exemption from regulation. *Id.*

164 As the court responded to the defendant's claims, Tauber's two chief arguments formed the structure of the court's analysis. *See supra* notes 29-30 and accompanying text.

165 The most important aspect of these principles is the sole reliance on the words of the statute when the intent of Congress is apparent on the face of the statute. When the intent is clear, a court will not analyze legislative history. *See supra* note 51 and accompanying text.

166 Tauber II, 8 F.3d 966, 976 (4th Cir. 1993). The court also addressed Tauber's argu-

The Fourth Circuit determined that once the plain meaning of the statute is determined from the face of the statute, no further analysis is warranted. This strict interpretation of the words of Congress led the court to reframe the issue when analyzing the legislative history[167] and also to engage in a summary analysis of prior cases interpreting the Treasury Amendment.[168] As a result, the court underemphasized the interpretations of the Treasury Amendment from other authority and relied principally upon its own interpretation of the statute.

The court's mechanical reading of the phrase "transactions in" foreign currency without resort to outside authority also resulted in the court's refusal to distinguish forwards, futures, and options. As a regulatory matter, futures and options are much the same; both are regulated on an equivalent basis by the CEA.[169] However, forwards differ greatly from futures and options in the regulatory framework. Early in the case, the court sharply distinguished futures from forwards. Interpreting the Treasury Amendment, however, the court lumped the two contracts together. The court's examples of the similarities in the contracts is correct, but this analysis ignores the sharply different treatment of the contracts under the CEA and defies the distinction between these contracts established in the CEA. The court's strict reading clouds the regulatory distinction of these contracts and shows a lack of appreciation of the importance of the difference between futures and forwards.

In short, the court, in its step-by-step mechanical interpretation of the statutory language, failed to consider the intricacies of the CEA and the financial transactions it regulates. By omitting a critical analysis of "transactions in" foreign currency, the Fourth Circuit glossed over a critical issue in the case. As discussed below, the court's reliance on its own interpretation guides its analysis of other authority.[170]

### 2. *The Legislative History:* Who *Is Exempt?*

As discussed above, the court responded to Tauber's second argument by exploring the legislative history.[171] As opposed to the Treasury Letter, the court determined that the statute exempts individuals as part of the interbank market.

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ment that the legislative history of the Treasury Amendment showed that only forwards should be exempt. According to the court, the Department of Treasury hoped to avoid regulation of "foreign exchange *futures trading*, other than on organized exchanges." *Id.* The court summarily concluded that the legislative history did not support Tauber's forwards argument. *Id.*

167 *See supra* notes 66-79 and accompanying text.

168 *See supra* notes 80-81 and accompanying text.

169 *See supra* notes 122-26 and accompanying text.

170 *See infra* notes 171-80 and accompanying text.

171 *See supra* notes 66-79 and accompanying text.

*a. Misinterpretation of the Treasury Amendment's Purpose*

The court's piecemeal construction of the Treasury Letter is logically consistent, but the analysis ignores the context of the Letter and the Amendment. The main purpose of the Treasury Letter was to alert Congress to the potential dual regulation of the banking industry by bank regulators and the CFTC. Just as the court cited numerous phrases referring to "traders and investors," the Letter abounds with references to a network of institutions, not individuals.[172] Although the Treasury Letter includes references to "dealers," and the identity of these "dealers" is ambiguous, the Department of Treasury's concern was clearly expressed in a single sentence: "Where the need for regulation of transactions on other than organized exchanges does exist, this should be done through strengthening existing regulatory responsibilities now lodged in the Comptroller of the Currency and the Federal Reserve."[173] Avoiding this assertion, the court chose specific phrases which cast doubt on whether an individual was a participant in the interbank market.[174] Taken as a whole, the Treasury Letter addressed the problem of CFTC encroachment upon bank regulators' jurisdiction. Although numerous phrases may be read to include individuals in the proposed exemption, such individuals could never be subject to banking regulation. Bearing in mind the *purpose* of the Treasury Letter, these individuals could not reasonably be included in the exemption under the Treasury Amendment. The court, by selectively reading the legislative history, missed the point of the exemption: the prevention of dual regulation, not the exemption of a broad range of traders.

*b. The General Public and the Individual Trader*

The court's analysis of the problem of mass-marketing to the general public illustrates ambiguity in its broad exemption of over-the-counter trades. After the court analyzed the legislative history and decided that the statute exempts all over-the-counter trading,[175] it qualified its analysis by declaring that its holding does not apply to transactions with the general public. The court's qualification reveals duplicity, and consequent ambiguity, in its analysis. While the court holds that the Treasury Amendment exempts all over-the-counter trades, it declares that this conclusion cannot apply to small investors. This analysis fails to clearly distinguish between regulation and exemption, and the holding carves out a category of traders in between clear

[172] For example, the Treasury was concerned about regulation of "banks or other institutions," Treasury Letter, *supra* note 13, at 5887, "sophisticated and informed institutions," "bank foreign currency departments," and "futures trading in foreign currencies by banks." *Id.* at 5888.

[173] *Id.* at 5888.

[174] *See supra* notes 69-70 and accompanying text.

[175] Tauber II, 8 F.3d 966, 977 (4th Cir. 1993).

exemption (institutions) and clear regulation (individual, small-time investors). The analysis creates a fact-specific exempted category: the "sophisticated trader."

### *3. Case Law: The Fourth Circuit Redefines the Issue*

The court's interpretation of the Treasury Amendment guided its interpretation of the case law. Under its scheme, *all* foreign currency transactions and any participant in the interbank market are exempt. However, as its analysis developed in light of other courts' holdings, the Fourth Circuit shifted its analysis. The court distinguished "sophisticated traders" from the general trading public.

First, the court addressed *American Board of Trade*, in which the defendants operated a contract market without CFTC registration.[176] In light of the Second Circuit's holding, the court determined that "the key factor for the Second Circuit in deciding the case was not the subject matter of the deals—options and futures in foreign currency—but the identity of the parties—unsophisticated private individuals buying on an organized exchange."[177] Therefore, the court viewed the fundamental issue as whether a member of the general public traded in futures and options.

The court noticeably omitted analysis of the Second Circuit's discussion of "transactions in" foreign currency. In *American Board of Trade*, the Second Circuit determined that an option on foreign currency could not be a "transaction *in*" the currency until the option was exercised. Unlike the summary treatment of options by the Fourth Circuit, the court in *American Board of Trade* scrutinized the meaning of the phrase in light of the function of option contracts. In contrast, the Fourth Circuit relied solely on its own interpretation of "transactions in" foreign currency.

Second, the court briefly mentioned *Board of Trade*, where the Seventh Circuit resolved a jurisdictional dispute between the SEC and the CFTC.[178] Here, the court summarily decided that off-exchange trading was not involved, so the case was inapplicable.

Like its discussion of *American Board of Trade*, the Fourth Circuit ignored the Seventh Circuit's analysis of options. Consistent with *American Board of Trade*, the Seventh Circuit held that an option could not be a "transaction in" the underlying commodity until the option was exercised. Yet the Fourth Circuit omitted discussion of the ambiguity surrounding "transactions in" foreign currency.[179]

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[176] *See supra* notes 157-60 and accompanying text.

[177] *Tauber II*, 8 F.3d at 977-78.

[178] *See supra* notes 149-56 and accompanying text.

[179] One aspect of the Fourth Circuit's reasoning which contradicts the Seventh Circuit is its construction of the "unless" clause of the Treasury Amendment. In contrast to the Fourth Circuit's use of the "unless" clause as a modification of the exemption, the Seventh Circuit considered this clause necessary to exempt futures or options when the contracts were per-

The Fourth Circuit's reframing of the issue is perplexing. The case law construing the Treasury Amendment does not reach the issue of off-exchange transactions among institutions, the analysis regarding options trading under the Treasury Amendment illustrates genuine ambiguity surrounding the phrase "transactions in" commodities. Yet the Fourth Circuit completely omitted this aspect of the case law, relying instead on its own construction of the "unambiguous" phrase. To buttress its interpretation, the court framed the issue as one of identity of traders: whether the participants were members of the general public or "sophisticated traders." Although consistent with its self-proclaimed standard of forgoing further inquiry once the statute is interpreted on its face,[180] the Fourth Circuit's analysis of the Treasury Amendment ignored the intricacies of the issue discussed in the case law.

*B. Policy Considerations after* Tauber

*1. The Regulatory Framework: The* "Tauber *Test"?*

The effect of this decision on the Federal regulatory framework is difficult to predict, but the regulatory scheme which *Tauber* establishes introduces ambiguity to federal commodities regulation. Under the *Tauber* scheme, an individual or an institution which could be considered a "sophisticated trader" would be exempt because "individually-negotiated foreign currency options and futures transactions between sophisticated, large-scale foreign currency traders fall within the Treasury Amendment's exclusion from CEA coverage."[181]

The Fourth Circuit's interpretive scheme establishes that: (1) the Treasury Amendment is a broad exemption to the CEA, exempting *all* trades; (2) the legislative history shows that the interbank market is composed of large-scale sophisticated investors; (3) based on the facts at the district court trial, *anyone* reasonably considered a "sophisticated trader" is included in the interbank market; and (4) this construction of the law cannot apply to the general public, as the CEA intends to regulate such trading. Because an individual, ordinarily a member of the general public, may trade over the counter if "sophisticated," the salient issue under the *Tauber* scheme is the definition of a "sophisticated trader."

The court summarily adopted the district court's determination that Tauber was a sophisticated trader.[182] Based on the facts of the

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formed. Board of Trade v. SEC, 677 F.2d 1137, 1154 n.33. The Seventh Circuit, in this footnote, implied that the Treasury Amendment's "unless" clause exempts only the "transactions in" a commodity when the underlying spot asset is exchanged. The Fourth Circuit failed to address this aspect of the Seventh Circuit's decision.

[180] *See supra* note 51 and accompanying text.

[181] *Tauber II,* 8 F.3d. at 978.

[182] *Id.* at 969. The procedural posture of the case prohibited a factual determination by the court of appeals.

case, this is a reasonable finding. However, this determination was the key to finding that Tauber was included in the interbank market. As mentioned above,[183] the court's holding exempts the interbank market but does not apply to the general public. Therefore, *Tauber* commands the courts to determine, on a case-by-case basis, whether an individual trader is sufficiently sophisticated to be included in the interbank market. The scheme lacks a bright-line rule for regulation, and the exemption issue must turn on the fact-specific inquiry of whether an individual is a "sophisticated trader."[184] Although courts may borrow guideposts of who is sophisticated from other areas of the law,[185] each case will be determined on its own facts.

The most troubling aspect of *Tauber* is that it pokes a hole in the federal regulatory scheme. Under the Fourth Circuit's holding, an individual trader whose volume and skill in trading reaches a sufficient level will achieve exemption from the CEA.[186] Individuals are exempt from federal banking regulations, and the subject matter of the trades are beyond the federal securities laws.[187] Therefore, individual traders in this market could trade in foreign currency derivatives with no government oversight.[188] According to the *Tauber* decision, these individuals could even be exempt from the CEA anti-fraud provisions.[189]

The true effects of *Tauber* may be overestimated. The central trading center in the United States for interbank foreign currency trades is New York, and the prospects of the Fourth Circuit becoming a base for trading are slim. However, as legal precedent, the *Tauber* decision could affect decisions among the circuits, as none have directly addressed this issue.[190]

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[183] *See supra* notes 76-79, 175 and accompanying text.

[184] Exempting a "sophisticated trader" from CFTC rules resembles the securities regulation exemption of "accredited investors." 17 C.F.R. §§ 230.501-230.506 (1993). An accredited investor includes a person whose individual net worth (or joint net worth with spouse) exceeds $1,000,000 or whose individual annual income exceeds $200,000 for the past two years. If an individual qualifies as an accredited investor, the registration requirements of the Securities Act do not apply. 17 U.S.C. § 77(d)(6) (1988). *See also* THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 4.20 (2d ed. 1990).

[185] The most similar standard of sophistication is the exemption of accredited investors under the securities laws. *See supra* note 184.

[186] This is much more than a theoretical analysis. An example of a "sophisticated trader" is George Soros, the Hungarian-born American trader. Last year, he reportedly cleared a $1 billion profit on speculation in the British Pound. He is also accused of upsetting the currency market in Europe. *See Soros Adds to Pressure on European Exchange Rate System*, L.A. TIMES, July 31, 1993, at D1.

[187] *See generally* Chicago Mercantile Exch. v. SEC, 883 F.2d 537 (7th Cir. 1989) (determining CFTC and SEC jurisdiction regarding hybrid instruments).

[188] Indeed, these individuals, as Tauber did, would probably trade with brokers and institutions already subject to federal regulations. However, according to *Tauber II*, federal law currently does not directly regulate individuals trading for themselves in foreign currency derivatives.

[189] As the Treasury Amendment states: "*Nothing in this act* shall be deemed to govern . . . transactions in foreign currency." 7 U.S.C. § 2(ii) (Supp. IV 1992) (emphasis added).

[190] The *Tauber* analysis and the interbank market as a whole, may be subject to legislation in the near future. In a report immediately following the *Tauber I* decision, the CFTC

2. *Tauber's Effect on the Foreign Exchange Market*

The effect of *Tauber* on the foreign exchange market is virtually unpredictable. However, the court's decision will exempt a portion of the market and may promote trading in the United States.

The most basic application of *Tauber* is the addition of more traders to the interbank market. The court's definition of a "sophisticated trader" defies precise definition. But as a general principal, the fact-specific test that the case establishes will exempt more market participants from CFTC regulation. If more traders are included in the definition of a "sophisticated trader," the foreign exchange market should expand.

Secondly, the foreign currency exchange market presents special regulatory questions because, unlike domestic commodities, foreign exchange trading can move overseas to jurisdictions which impose less stringent regulations. Wherever regulations are most favorable to foreign currency trading, international traders will most likely choose that jurisdiction in which to trade.[191] If *Tauber* deeply affects the American regulatory scheme, more foreign currency traders will move to the United States to enjoy the lighter regulations.

Third, under the *Tauber* scheme, certain individual traders will enjoy trading with no federal oversight. These "sophisticated traders" can significantly affect the market. One example is George Soros,[192] who reaped trading profits of $650 million in 1993 and was suspected of single-handedly upsetting the exchange rate of the British pound. His conduct prompted one U.S. Congressman to ask the SEC to inquire into the possibility of a single trader adversely affecting foreign exchange rates.[193] From a fact-specific inquiry, Soros is certainly a "sophisticated trader." Ultimately, participants in the foreign exchange

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expressed concern about the clarity of the analysis. COMMODITY FUTURES TRADING COMMISSION, *supra* note 41, at 156. The Commission emphasized that the Treasury Amendment should in no way exempt futures and options offered to the general public. Accordingly, "the Commission will consider recommending to Congress legislation that would affirm the CFTC's view that the Treasury Amendment does not extend to the sale of futures or options in foreign currencies to the general public." *Id.* The Commission has also explored coordination of the regulatory systems which oversee derivatives, futures, and securities. Although the CFTC approves of the current multi-agency effort (the CFTC, the SEC, and the bank regulators), it advocates an interagency coordinating council. *Id.* at 157-74.

The idea of an interagency commission is supported by Rep. Jim Leach (R- Iowa) in his recent proposal to regulate the derivatives industry. In October, Leach presented a report prepared by the House Committee on Banking and Finance. COMMITTEE ON BANKING, FINANCE, AND URBAN AFFAIRS, SAFETY AND SOUNDNESS ISSUES RELATED TO BANK DERIVATIVES ACTIVITIES (October 1993). In this report, the Committee suggests a number of coordinating measures between the banking, securities, and commodities regulators that would assure interagency cooperation in regulating the derivatives industry. *Id.* at 5.

191 A chief argument for the *amici curiae* arguing for Salomon was the potential for traders to take their business off-shore, thereby adversely affecting the trading market in the United States.

192 *See supra* note 186.

193 Mathews, *supra* note 1.

market who operate without regulation may harm the entire industry.[194]

These conclusions are based on the assumption that *Tauber* will significantly affect the foreign exchange market, and currently there is no firm indication that such a result is imminent. However, by creating the "sophisticated trader" exemption, the Fourth Circuit obscured the standards of commodity futures regulation and presented an opportunity for large-scale, individual traders to trade without regulation.

## VI. Conclusion

The Fourth Circuit's holding hinged upon a strict, mechanical analysis of the words of the Treasury Amendment. This analysis guided the court's construction of the legislative history of the amendment and the case law which had interpreted it. Once the court discerned the intent of Congress from the words of the statute, further analysis was inconsequential.

This rigid analysis overlooked the intricacies of the issue and produced a result at odds with the current regulatory scheme. The Fourth Circuit established that the Treasury Amendment exempts all transactions in foreign currency when traded over the counter, but the exemption could not apply to the general public. The result is a fact-specific category of sophisticated traders who are exempt from the CEA. By introducing the ambiguity of case-by-case exemptions under the Treasury Amendment, the Fourth Circuit rejected bright-line regulatory rules, opened the foreign currency market to unregulated traders, and clouded the standards of commodity futures regulation.

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194 The most prominent counter-argument to protecting the market against traders reflects the securities regulation theme of protecting only those investors who need protection of the federal law. *See supra* note 184. Sophisticated traders such as Soros need no protection because they are fully capable of anticipating risks in trading. This argument is founded on the belief that the commodity regulations should protect investors individually rather than as a group or the market as a whole.

Currently, government officials are split as to the treatment of these traders. *See supra* note 190. Some members of Congress favor stronger market controls to limit market fluctuation, see *supra* note 190 and accompanying text, but the CFTC does not share such a restrictive view of such traders. *See supra* note 163 and accompanying text.